INDEPENDENT STRATEGY

Global Markets

Settembre 2019

A PARTING GIFT

INVESTMENT CONCLUSION

The ECB's latest stimulus package seeks to address several problems and does so quite neatly. Banks win, thanks to tiering and more generous TLTRO terms while more bond purchases will also contribute to the bottom line. That, the ECB hopes, will all help drive new lending.

We doubt it.

Draghi has also strengthened forward guidance. Not only have timeframes been jettisoned but the ECB has explicitly linked the mandated inflation objective and underlying (core) inflation.

That is a dovish step, even if it brings its own potential complications given how static core inflation has been.

All of these measures should contribute to a weaker euro over both the short and medium-term. We maintain our $1.04 per euro target for the end of this year. These steps also create further support for Eurozone fixed income markets, irrespective of whether you think prices are frothy or that negative rates are irrational.

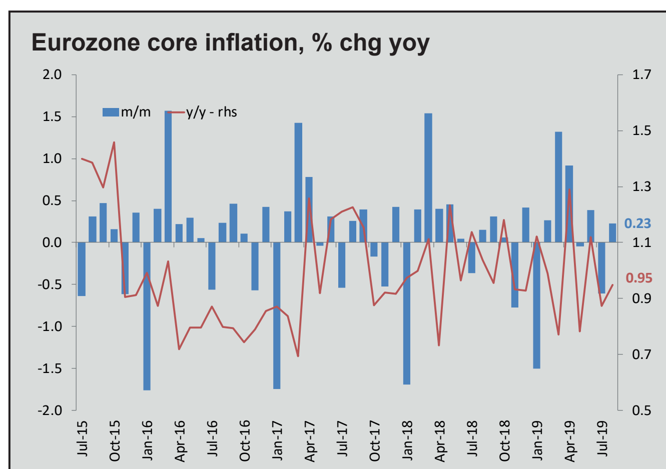

Figure 1. *Source: ECB, Independent Strategy*

ANALYSIS

While Mario Draghi will chair one final ECB meeting in October, the extensive package of measures announced on Thursday are really his parting gift.

The Governing Council has approved tweaks to nearly all of its policy levers while also adding some further guidance on what it is looking for on the inflation side. It complemented its usual observation on returning headline inflation to its targeted level by adding that it also needs to see convergence in underlying inflation dynamics. Given how stubbornly disappointing core inflation has been across the Eurozone (Figure 1) this shift is a potentially killer blow to the hawks who might have hoped for more influence once Draghi exited the stage. Of all the measures announced this detail to us looks the most significant given how it anchors

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the policy bias, perhaps in a way that's actually counterproductive to a central bank that wants observers to relate to higher inflation rates rather than lower. The crux of the package was as follows. It was less than the expectations of some significant institutions, but matched published market expectations. The deposit rate was lowered 10bps to -0.50% (a chunk were looking for a 20bps reduction but that looked a little ambitious), while the marginal lending and repo rates were unchanged (Figure 2). Alongside this, a new asset purchase programme (APP2) was delivered, which will buy €20bn of bonds per month "for as long as necessary".

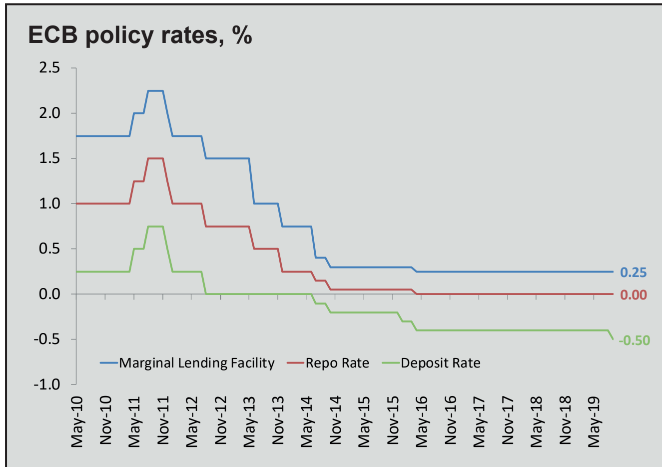

Figure 2. *Source: ECB, Independent Strategy*

The omission of a time limit was a surprise, the council merely stating that it would end shortly before it starts to raise the key ECB interest rate. QE-infinity indeed!

And of course the existing commitment to reinvest proceeds of maturing securities applies to this expanding stock. Pacing new asset purchases like this neatly calibrates the programme to avoid running into the 30% issuer limit in the visible future and the potential legal problems that exceeding that constraint might bring.

It did not end there. Debate about the damage negative rates have done to the banking sector (based on feedback from the banking sector) was sufficient to tip the ECB into creating a two-tiered reserve system, allowing banks to shield some of their excess liquidity - defined as reserve holdings in excess of minimum reserve requirements - from the costs of the negative deposit rate. It does not completely exempt banks from paying this charge, the exemption applying to a multiple of each institution's specific reserve requirement. This technical detail means change is more limited than Draghi first implied, but it provides the opportunity to adjust the multiple of deposits exempt from paying the deposit rate further going forward, as well as creating space for further deposit rate cuts. But it's equally another sign that monetary policy has reached its practical limits, with trade-offs now needed to facilitate transmission. And that's even before making the general

observation that this easing package merely nudges short-term rates closer to existing market pricing. So there is no reason to expect that these decisions will deliver any meaningful confidence boost to the real economy, irrespective of what the governing council might officially say. That's a consequence of operating behind the curve, where the ECB's institutional biases keep it.

Banks received a further bone in the form of adjustments to the TLTRO III programme. Now "*for banks whose eligible net lending exceeds a benchmark, the rate applied in TLTRO III operations will be lower, and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation*". Previously those meeting the lending criteria paid 10bps above the deposit rate. The ECB has also extended the term of these loans from two to three years, which kicks the rollover issue further into the long grass. The outstanding question is whether such a programme will actually increase lending? The ECB seems to think so. But given growth risks, the general fragility of some country banking sectors and the deleveraging this is encouraging, as well as recent history, we remain cautious.

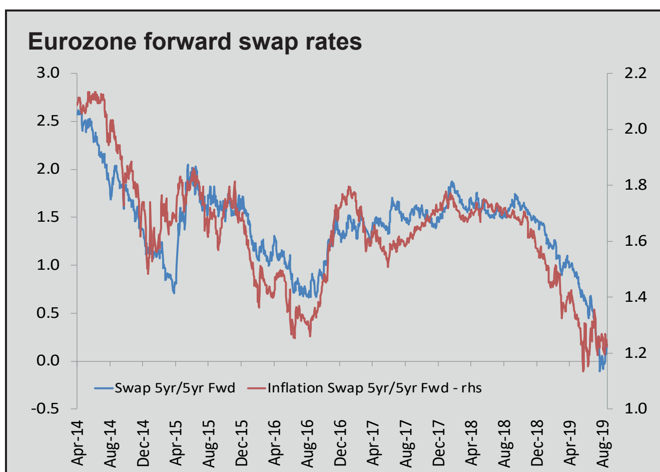

Figure 3. *Source: Datastream, Independent Strategy*

Draghi was at pains again to stress the need for structural reforms to boost productivity and reduce structural unemployment rates in the region. Fiscal policy was providing some support he added, but Draghi took the opportunity to state that it was time for those with fiscal space to respond in a timely manner to risks and pursue more growth-friendly policies to help the ECB meet its price stability targets. A pretty clear swipe at the Germans!

The President added explicitly that fiscal policy should become the main instrument to raise demand and that governments should now take charge. Interestingly this was the only area where there was unanimity across the governing council. This seems eminently sensible, but it's worth noting that the fiscal stimulus being discussed - such as infrastructure spending and new packages to combat climate change - is only likely to deliver over the medium-term, and thus the prospect of any immediate impact on the inflation outlook is negligible.

This seems to contradict somewhat the ECB's stated belief that this easing package is more than adequate to reach the governing council's objectives, but does fit neatly with the appointment of Christine Lagarde - due to be confirmed in October - who has been a vocal proponent of more coordinated fiscal action and has the charm to sell it to national governments. Inflation forecasts were revised down again across the horizon. Draghi glossed over falling inflation expectations, spinning their drop as them re-anchoring at lower levels rather than declining *per-se*. But this looks a rose-tinted interpretation, certainly based on market measures (Figure 3). The slowdown in Eurozone growth has

also been more protracted than the governing council expected. And the ECB's model treated the main macro risks - the trade war and adverse outcomes to Brexit negotiations - rather favourably. So clearly this gloomy assessment still comes with downside risks.

Draghi's ability to deliver has long been impressive and his policy swansong should be viewed in a similar light. It attacks the problem from four directions with a rate cut, more QE, tiering and adjustments to the TLTRO III programme. That latter two should be warmly welcomed by the banking sector given the break it cuts them in the face of margin pressures from negative rates. It also reduces the risk that negative rates will be passed on to the retail deposit sector, something that has begun to happen in Switzerland. This is certainly a sop to the German saver, whether they appreciate it now or not.

Guidance was also significantly shifted, not just in terms of abandoning a timetable for hitting these goals but more importantly by clarifying what meeting the inflation target actually means, not just a sustained rate of headline inflation but signs that underlying (core) inflation, driven by domestic demand, has taken hold. Core has been stubbornly low for a long time, so effectively this ties the ECB to easy and easier policy for even longer.

While the euro bounced from its initial lows it's difficult to see how any of the ECB's goals can be reached with the currency at these kind of levels. Or more specifically the risks that any currency appreciation would generate for the inflation outlook and inflation expectations would be significant. So while we might not be on the cusp of a euro collapse, the gradual but persistent depreciation we've seen over the past two years will continue.

We expect the euro to fall to $1.04 over the remainder of the year and medium-term see the single currency below parity. That backdrop also keeps the fixed income markets underpinned, not just in terms of asset purchases but the prospect that policy rates will remain negative beyond the average duration of most countries' debt stock. It would take a real fiscal reformation to alter that.

Documento preparato per i collocatori di ARCA FONDI SGR

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